



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

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| Date Amended: | 07/21/01 | Bill No: | AB 426 |
| Tax: | Sales and Use | Author: | Cardoza, et al. |
| Board Position: | | Related Bills: | AB 7 (Cardoza) AB 904 (Briggs) AB 1198 (Matthews) AB 16xx (Briggs) |

BILL SUMMARY

This is a budget trailer bill implementing various provisions incorporated into the 2001-02 Budget. This bill would, among other things, provide the following:

1. An extension of the $\frac{1}{4}$ percent state General Fund rate reduction if the General Fund revenues equals a specified amount. (Sections 6051.45 and 6201.45)
2. A state* and local sales and use tax exemption for the sale and purchase of liquefied petroleum gas (LPG) that is delivered to a "qualified residence," as defined, by the seller, that is sold for household use in the qualified residence, and LPG that is purchased by qualifying persons, as defined, for use in producing and harvesting agricultural products. (Section 6353)**
3. A state* sales and use tax exemption on sales and purchases of farm equipment and machinery for use by a qualified person engaged in producing and harvesting agricultural products, or purchased by a person who assists such qualified persons in producing and harvesting agricultural products, as specified. (Section 6356.5)**
4. A state* sales and use tax exemption for sales and purchases of equipment and machinery designed primarily for off-road use in commercial timber harvesting operations, and the parts thereof, that is purchased for use by a qualified person to be used primarily in harvesting timber. (Section 6356.6)**
5. A state* sales and use tax exemption for sales of diesel fuel used in food processing and in farming activities, including transporting farm products to the marketplace, beginning no later than September 1, 2001. (Section 6357.1)
6. A state sales and use tax exemption for the sale and purchase of any race horse breeding stock, as defined. (Section 6358.5)**

*** While the state tax rate is 4.75 percent for calendar year 2001, it is assumed that the tax rate will return to 5.0 percent in 2002. Therefore, prior to January 1, 2002, these provisions will result in a 4.75 percent state sales and use tax exemption. On and after January 1, 2002, these provisions will result in a 5.0 percent state sales and use tax exemption.**

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

**** The operative date of these provisions would be September 1, 2001, or, October 1 if the Board determines that implementation by September 1 is not feasible. In such a case, the Board would be required to report to the Legislature on the reasons why it must delay implementation.**

ANALYSIS

Sales Tax Rate Reduction:

Current Law

Under existing law, Sections 6051.3 and 6201.3 of the Revenue and Taxation Code provide for the imposition of a 1/4 percent State General Fund sales and use tax rate. Sections 6051.4 and 6201.4 specify that the 1/4 percent rate imposed by these sections ceases to be operative on and after January 1 following any November 1 in which the Director of Finance certifies that:

- the amount in the Special Fund for Economic Uncertainties as of June 30 of the prior fiscal year exceeded 4 percent of General Fund revenues for that prior fiscal year, and
- the estimated amount in the Special Fund for Economic Uncertainties as of June 30 of the current fiscal year (without including any revenue derived from the 1/4 percent rate on and after January 1 of the current fiscal year) exceeds 4 percent of General Fund revenues for the current fiscal year.

Currently, a base state and local sales and use tax rate of 7 percent is imposed as noted below:

- 4 3/4 percent state tax allocated to the state's General Fund (Sections 6051 and 6201).
- 1/2 percent state tax allocated to the Local Revenue Fund which is dedicated to local governments for program realignment (Sections 6051.2 and 6201.2).
- 1/2 percent state tax allocated to the Local Public Safety Fund which is dedicated to local governments to fund public safety services (Sec. 35 of Article XIII of the California Constitution).
- 1 1/4 percent Bradley-Burns Uniform Local Sales and Use Tax which is allocated to cities and counties (Part 1.5 (commencing with Section 7200)).

An additional local district tax ranging from 1/8 to 1 1/4 percent (referred to as Transactions and Use taxes) is imposed by special taxing jurisdictions in various counties and cities within the state (Part 1.6 (commencing with Section 7252)).

Also, as noted above, Sections 6051.3 and 6201.3 impose a 1/4 percent state tax, which is allocated to the state's General Fund. However, the tax imposed by these sections ceased to be operative January 1, 2001 since the specified conditions above have occurred.

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Proposed Law

This bill would add Sections 6051.45 and 6201.45 to provide that the ¼ percent state sales and use tax provided for in Section 6051.3 and 6201.3 shall not be operative in any calendar year beginning on or after January 1, 2002, provided the Director of Finance determines that the General Fund reserve is 3 percent of revenues excluding the revenues derived from the ¼ cent sales and use tax rate and actual General Fund Revenues for the period May 1 through September 30 equal or exceed the May Revision forecast, prior to the November 1 determination.

Background

Sections 6051.3, 6051.4, 6201.3, and 6201.4 were added during the 1991 Legislative Session as part of a comprehensive package to address a \$14 billion state budget gap. At that time, the Legislature enacted SB 179 (Deddeh, Chapter 88, Statutes of 1991) and AB 2181 (Vasconcellos, Chapter 85, Statutes of 1991) to increase the sales and use tax rate by 1 1/4 percent as well as to repeal various sales and use tax exemptions.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to modify the provisions which would extend the 1/4 percent reduction in the state sales and use tax rate.
2. **Rate should increase to 5% January 1, 2002.** According to budget consultants, it is anticipated that, even with the modifications proposed in this measure, the ¼ percent rate will become operative January 1, 2002, since the General Fund revenues are not expected to exceed the level that would trigger the rate reduction.

COST ESTIMATE

This bill would not impact the Board's current administrative costs, since the 1/4 percent statewide tax rate reduction went into effect on January 1, 2001 in accordance with the provisions of existing law. However, in future years, without the enactment of this measure, if the reserve in the Special Fund for Economic Uncertainties were to fall below the 3 percent threshold, the law would reinstate the 1/4 percent tax. If that were to occur, the Board would incur costs in notifying the public, revising tax returns, reprogramming, and handling the increased computational errors on returns. The costs associated with implementing a 1/4 percent statewide sales and use tax rate change are estimated to be as follows:

| Implementation Costs | Ongoing Costs |
|----------------------|---------------------|
| <u>FY 2000-2001</u> | <u>FY 2001-2002</u> |
| \$977,000 | \$831,800 |

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REVENUE ESTIMATE

The provisions for the suspension of the $\frac{1}{4}\%$ rate were met during 2000-01 and the $\frac{1}{4}\%$ rate has been suspended for the 2001 calendar year.

Revenue Summary

Since the $\frac{1}{4}\%$ state sales and use tax rate has been suspended for calendar year 2001, this proposal would have no revenue effect for this year.

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Liquid Petroleum Gas:**Current Law**

Under existing law, sales or use tax applies to the retail sale of tangible personal property in this state, unless specifically exempted by statute. Section 6353 of the Sales and Use Tax Law currently provides an exemption from sales and use tax for the sale or use of gas delivered to consumers through mains, lines, or pipes. Thus, sales of LPG delivered to consumers through mains, lines, or pipes currently qualify for exemption from tax.

However, in order to qualify for the exemption under Section 6353, the LPG must be sold in vaporized form and delivered to the purchaser through mains, lines or pipes. The Board has determined that this requirement is met even if the gas is initially delivered in liquid form into a tank on the purchaser's premises if the tank belongs to the seller of the gas, or is leased by the purchaser to the seller and there is an explicit agreement between them stating that the seller retains title to and possession of the LPG until it is delivered in vapor form to the customer through the customer's mains or pipes. Virtually all sales of LPG for residential use, except for use in barbecues, could qualify for this exemption if the parties were to properly structure the transactions. However, not everyone takes advantage of this exemption in part because of the difficulty in understanding how to comply with its requirements. As a result, essentially identical sales of LPG are subject to tax, or not, based solely on whether the parties understand the requirements of the exemption.

Proposed Law

This bill would amend Section 6353 of the Sales and Use Tax Law to provide an exemption from sales and use tax for the sale and use of LPG delivered to a qualified residence by the seller that is sold for household use in the qualified residence, and LPG purchased for use by a qualified person, as defined, to be used in producing and harvesting agricultural products, provided in both cases, the LPG is delivered into a tank with a storage capacity for LPG that is equal to or greater than 30 gallons.

The bill would define "qualified residence" to mean a primary residence, not serviced by gas mains and pipes, and "qualified person" as any person engaged in a line of business described in Codes 0111 to 0291 of the Standard Industrial Classification Manual and any other person that assists that person in the lines of businesses described in producing and harvesting agricultural products.

The provisions of this portion of the bill would become effective September 1, 2001, or, October 1 if the Board determines that implementation by September 1 is not feasible. In such a case, the Board would be required to report to the Legislature on the reasons why it must delay implementation.

Background

The original Retail Sales Tax Act, enacted in 1933, provided the current exemption from sales and use tax of gas, electricity, and water when delivered to consumers through mains, lines or pipes.

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Chapter 402 of the Statutes of 1972 expanded this exemption to include water sold in bulk quantities of 50 gallons or more for general household use if the residence is not serviced by mains, lines, or pipes.

Chapter 1010 of the Statutes of 1978 included exhaust steam, waste steam, heat or resultant energy, produced in connection with cogeneration technology.

Chapter 420, Statutes of 1986, specified that water delivered through mains, lines or pipes, for purposes of the exemption, includes steam and geothermal steam, brines and heat.

Bills similar to AB 426 have been considered in the past. During the 2000 Legislative Session, AB 1788 (Machado) was held in the Assembly Appropriations Committee. During the 1999 Legislative Session, AB 214 (Machado) was held in the Assembly Appropriations Committee. In the 1997-98 Legislative Session, AB 1019 (Machado) was held in the Senate Appropriations Committee. In the 1995-96 Session, SB 1455 (Leslie) failed passage in the Senate Revenue and Taxation Committee. The Board voted to support AB 1788, and took a neutral position on the remainder of the bills.

Other bills proposing to exempt various fuel and gas substances for residential use not delivered through mains, lines or pipes include: AB 149 (Chappie) of the 1977-78 session, AB 359 (Chappie) of the 1979-80 session, AB 10 (Kelly) and AB 130 (Lockyer) of the 1981-82 session, AB 2203 (Kelly) of the 1983-84 session, AB 2117 (Hannigan) and AB 2562 (Seastrand) of the 1985-86 session and AB 127 (Areias) of the 1987-88 session.

COMMENTS

- 1. Sponsor and purpose.** The author is the sponsor of this bill and its purpose is to provide equal tax treatment for those who must use liquefied petroleum gas in their residences, as well as to alleviate the financial hardship that the energy crisis is causing the agricultural sector. The residences of the majority of affected consumers are not located in areas serviced through mains, lines, or pipes. Their purchases of LPG can qualify for the existing exemption only when they meet all the requirements for that exemption even though these consumers use the LPG for cooking and heating just as other consumers who reside in areas serviced through mains, lines, and pipes use electricity and natural gas.
- 2. A qualified residence would only include a primary residence.** The proposed exemption would not apply to sales of LPG to be used in a vacation home. LPG sellers would need to document that the sale was made to a person in their primary residence in order to support the claimed exempt sale. It is unclear how a purchaser would document to the LPG seller that the delivery is being made to a primary residence versus a vacation home.

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- 3. The record-keeping of LPG sellers would change.** Many LPG sellers provide a complete LPG service. In other words, in addition to selling LPG for residential purposes, many sell for commercial, industrial, agricultural, motor fuel, and forklift purposes. Enactment of this provision would require LPG sellers to separately account for LPG sold for qualified residential and agricultural uses from other nonqualifying sales for purposes of filing sales and use tax returns and reporting the tax.
- 4. Related legislation.** AB 1198 (Matthews), which the Board voted to support, is similar to this provision, except AB 1198 did not include an exemption for LPG used for agricultural purposes. Another measure, AB 1388 (Aanestad), would exempt all sales of propane gas from the sales and use tax. The Board voted to be neutral on AB 1388.

COST ESTIMATE

Some costs would be incurred in notifying affected retailers, and verifying deductions claimed on LPG sellers' sales tax returns. These costs would be absorbable.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

The U.S. Energy Information Administration in its publication, Residential Energy Consumption in 1997, has published the following information regarding residential consumption of and expenditures for liquefied petroleum gas (LPG).

| | Households | Consumption | Expenditures |
|---------------|-------------|-----------------------|--------------|
| LPG Use | (thousands) | (millions of gallons) | (millions) |
| Space heating | 200,000 | 81 | \$ 90 |
| Water Heating | 300,000 | 84 | 100 |
| Appliances | 300,000 | <u>18</u> | <u>20</u> |
| Total | | <u>183</u> | <u>\$210</u> |

Some of the LPG sold for residential use is already exempt under Section 6353 because the gas was delivered through mains, lines or pipes. The Board has determined that the requirements of Section 6353 have been met even if the propane is initially delivered in liquid form to a tank on the purchaser's premises if the tank belongs to the seller of the propane, or is leased by the seller from the purchaser, and there is an explicit agreement between them passing title to the gas at the time it enters the customer's pipes in vapor form.

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Based on information derived from a survey conducted by the Board on propane dealers in California, we estimate that approximately 35 percent of the LPG sold for residential use is currently exempt. The total expenditures that would be exempted by this provision would be \$137 million ($\$210 \text{ million} \times 65\% = \137 million).

Based on information obtained from the American Petroleum Institute, sales of LPG for farm use is estimated to be \$28.1 million annually.

The total amount of LPG sales that would be subject to the provisions of this bill would be \$165.1 million.

Revenue Summary

The annual revenue loss from exempting LPG sold for household use in qualified residences from the sales and use tax and for farm use would be as follows:

| | |
|--------------------------|-------------------------------|
| State (5%)* | \$ 8.3 million |
| Local (2.25%) | 3.7 million |
| Special District (0.67%) | <u>1.1 million</u> |
| Total | <u><u>\$ 13.1 million</u></u> |

*While the state tax rate is 4.75 percent for calendar year 2001, it is assumed the tax rate will return to 5.0 percent in 2002.

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Farm Equipment and Machinery:**Current Law**

Under existing law, the sales or use tax applies to the sale or use of tangible personal property in this state, unless otherwise exempted or excluded by statute. Under current law, the sales and use tax applies to sales and purchases of farm equipment, including tractors, to the same extent as it applies to any other sale of tangible personal property that is not otherwise exempted or excluded from tax by statute.

The Sales and Use Tax Law provides some exemptions related to the agricultural industry, as follows:

- Tax does not apply to the sale or purchase of any form of animal life or seeds and plants of a kind, the products of which ordinarily constitute food for human consumption (e.g., sales or purchases of cows, bees, chickens, strawberry plants, and citrus seeds are exempt from tax).
- Sales or purchases of feed for “food” animals and fertilizer for “food” plants are exempt from sales and use tax.
- The sale and purchase of drugs and medicines administered to animals as additives to feed or drinking water are exempt if the primary purpose is to prevent and control disease of “food” animals or of animals which are to be resold.
- Other drugs and medicines, the primary purpose of which is the prevention or control of disease, that are administered to “food” animals are exempt.

Proposed Law

This bill would add Section 6356.5 to the Sales and Use Tax Law to exempt from the State’s General Fund portion of the sales and use tax (5%), sales and purchases of farm equipment and machinery, and the parts thereof, purchased by a qualified person for use primarily in producing and harvesting agricultural products.

The bill would define “qualified person” as any person engaged in a line of business described in Codes 0111 to 0291 of the Standard Industrial Classification Manual, and any other person that uses farm equipment and machinery to assist such persons in producing and harvesting agricultural products.

The bill would define “farm equipment and machinery” as implements of husbandry, as defined in Section 411.

The provisions of this portion of the bill would become effective September 1, 2001, or, October 1 if the Board determines that implementation by September 1 is not feasible. In such a case, the Board would be required to report to the Legislature on the reasons why it must delay implementation.

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Background

There have been several bills considered in the past to provide a partial exemption for sales of agricultural-related equipment. These include:

AB 3089 (1993-94) which would have provided a five percent sales and use tax exemption with respect to tangible personal property purchased by new businesses engaged in the production of food, fiber, and other agricultural commodities. This bill failed passage in the Assembly Revenue and Taxation Committee.

AB 208 (1995-96), similar to AB 3089 above, was amended in the Assembly Revenue and Taxation Committee to delete these sales and use tax provisions.

AB 138 (1997-98), also similar to AB 3089 and AB 208, died in the Assembly Appropriations Committee.

SB 38 (1997-98) would have provided a five percent sales and use tax exemption for sales of implements of husbandry to new businesses engaged in agricultural production or agricultural services. This measure failed passage in the Senate Revenue and Taxation Committee.

SB 818 (1999-00) would have provided a five percent state sales and use tax exemption for tangible personal property purchased by new businesses for use in post-harvesting activities of agricultural commodities. This measure failed passage in the Senate Revenue and Taxation Committee.

COMMENTS

- 1. Sponsor and purpose.** This bill is sponsored by the author and is intended to provide an exemption for the farming industry in conformity with other states. Proponents state that California is one of only four states that currently imposes a sales and use tax on farm equipment.
- 2. Partial exemptions are difficult for both retailers and the Board.** If this partial exemption is enacted, retailers of farm equipment and machinery would be required to program their registers to compute only the applicable local and district taxes on their sales of farm equipment and machinery. In addition, they would have to segregate in their records sales subject to the partial exemption, sales with a complete exemption (such as the sale of a strawberry plant), and sales that are fully taxable. This would add a new level of complexity, which would create a corresponding increase in errors in reporting the tax to the Board. This increase in errors would complicate the Board's administration of the sales and use tax laws.
- 3. Related legislation.** This provision is similar to this year's AB 7 (Cardoza) which the Board voted to support.

COST ESTIMATE

Some costs would be incurred in notifying affected retailers, verifying deductions on returns, and verifying claimed exemptions in audits. An estimate of these costs is pending.

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REVENUE ESTIMATE**Background, Methodology, and Assumptions**

In May 1997, the Far West Equipment Dealers Association (Far West) surveyed their California member dealers for sales of new and used farm equipment. Forty-eight dealers responded to the survey and reported sales of \$125.4 million. Expanding these amounts to all 124 California member dealers results in sales of new and used farm equipment of \$323.8 million.

The North American Equipment Dealers Association (NAEDA) has produced statistics showing that the average California farm equipment dealer has sales of new and used farm equipment amounting to \$4.7 million annually. There are 140 California dealers who are members of NAEDA. Expanding the average sales to all 140 dealers results in total sales of farm equipment of \$648 million. This study is based on a survey of 24 California dealers.

Far West believes that the NAEDA results are high due to the fact that the dealers included in that study were larger multi-store dealers and not representative of the whole market. Based on the results from the two studies mentioned above and discussions with Far West, farm equipment sales are estimated to be \$450 million annually.

Revenue Summary

The annual revenue loss attributable to exempting the \$450 million in sales of farm equipment and machinery from the 5% state sales and use tax is estimated to be \$22.5 million.

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Timber Harvesting Equipment:**Current Law**

Existing law imposes a sales or use tax on the gross receipts from the sale of, or the storage, use, or other consumption of, tangible personal property, unless specifically exempted by statute. Under existing law, sales of machinery and equipment for timber harvesting are subject to sales or use tax to the same extent as sales of any other tangible personal property not specifically exempted or excluded by law.

Proposed Law

This bill would add Section 6356.6 to the Revenue and Taxation Code to provide a state General Fund sales and use tax exemption for the sale and purchase of equipment and machinery designed primarily for off-road use in commercial timber harvesting operations, and the parts thereof, that is purchased for use by a qualified person to be used primarily in harvesting timber.

The bill would authorize the Board to adopt emergency regulations to specify equipment and machinery exempted by this section.

The bill would define “qualified person” as any person engaged in commercial timber harvesting.

The provisions of this portion of the bill would become effective September 1, 2001, or, October 1 if the Board determines that implementation by September 1 is not feasible. In such a case, the Board would be required to report to the Legislature on the reasons why it must delay implementation.

COMMENTS

- 1. Sponsor and purpose.** This provision is sponsored by the author and is intended to reduce the acquisition costs of timber harvesting machinery and equipment through a state tax exemption.
- 2. Partial exemptions are difficult for both retailers and the Board.** If this partial exemption is enacted, retailers of timber harvesting equipment and machinery would be required to program their registers to compute only the applicable local and district taxes on their sales of farm equipment and machinery. In addition, they would have to segregate in their records sales subject to the partial exemption and sales that are fully taxable. This would add a new level of complexity, which would create a corresponding increase in errors in reporting the tax to the Board. This increase in errors would complicate the Board’s administration of the sales and use tax laws.

COST ESTIMATE

Some costs would be incurred in notifying affected retailers, verifying deductions on returns, and verifying claimed exemptions in audits. An estimate of these costs is pending.

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REVENUE ESTIMATE

It is estimated that the annual State General Fund loss attributable to this provision would amount to \$2 million.

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Diesel Fuel:**Current Law**

Existing law imposes a sales or use tax on the gross receipts from the sale of, or the storage, use, or other consumption of, tangible personal property, unless specifically exempted by statute. Under existing law, sales of diesel fuel are subject to sales or use tax.

Section 6385 of the Revenue and Taxation Code provides a sales tax exemption for that portion of fuel and petroleum products sold to a water common carrier that is left on board after the water common carrier reaches its first out-of-state destination. With respect to air common carriers, Section 6357.5 provides an exemption for the sale or purchase of fuel and petroleum products sold to air common carriers when the fuel and petroleum products are for immediate consumption or shipment in the conduct of the air carrier's business on an international flight.

Current law provides that the sales tax revenue from the sale of diesel fuel is allocated on a quarterly basis to the Public Transportation Account. The money transferred to the Public Transportation Account is generally used to fund public transit projects.

Proposed Law

This bill would add Section 6357.1 to the Sales and Use Tax Law to provide a state General Fund sales and use tax exemption commencing no later than September 1, 2001, for the sale and purchase of diesel fuel used in farming activities and food processing.

The bill would define "farming activities" by reference to Section 263A of the Internal Revenue Code, and further would specify that "farming activities" also includes the transportation and delivery of farm products to the marketplace.

Background

Three bills were introduced last year to provide varying exemptions for sales of gasoline and diesel fuel. Assembly Bill 1706 (Strickland, et al.) would have provided a sales and use tax exemption for sales of gasoline and diesel fuel. AB 1706 was amended in the Assembly Revenue and Taxation Committee to remove the tax exemption language from the bill. Assembly Bill 43 (Villaraigosa) would have provided a 5 percent state sales and use tax exemption for sales of gasoline and diesel fuel for the period June 1, 2000 through September 30, 2000. AB 43 was never heard in a policy committee. Senate Bill 1777 (Burton) would have provided a 5 percent state sales and use tax exemption for sales of gasoline and diesel fuel, and also would have created a Petroleum Windfall Profits Tax that would have been imposed on refineries for failing to pass on the tax exemption savings to consumers. SB 1777 was never heard in a policy committee. The Board was neutral on AB 1706, neutral, point out problems on AB 43 and in support of SB 1777.

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COMMENTS

1. **Sponsor and Purpose.** The author is the sponsor of this bill. Its purpose is to alleviate the financial hardship that the energy crisis is causing the agricultural sector.
2. **Definition of farming activities.** The proposed exemption would apply to sales of diesel fuel used in farming activities. This bill provides that “farming activities” is defined to have the same meaning as “farming business” as set forth in Section 263A of the Internal Revenue Code (IRC). IRC 263A provides for the capitalization and inclusion of inventory costs of certain expenses. This section refers to items produced by a taxpayer in a farming business, such as any animal, or any plant which has a preproductive period of 2 years or less.
3. **“Food processing” is undefined.** The bill would additionally specify that the exemption include sales and purchases of diesel fuel used in food processing. It is unclear what the intent of this provision is. Would the exemption apply to diesel fuel used in a forklift at a bakery, or used in a diesel-powered generator at a grocery store? Absent a definition, disputes could occur between the Board’s and diesel fuel sellers’ interpretation.
4. **“Marketplace” is undefined.** The extent to which this proposed exemption would apply is unclear. For example, “marketplace” could mean the point at which the farm product is placed into the chain of commerce for processing, or it could mean the point at which the product is offered to consumers. As an example, would the diesel fuel used in trucks that are used to transport milk from the dairy farm to the dairy be exempt? What about the diesel fuel used to transport the milk from the dairy to the grocery store?
5. **Transportation funding would be reduced.** Current law provides that the sales tax revenue on sales of diesel fuel be transferred to the Public Transportation Account. The revenue transferred to this fund is used to pay for various mass transit projects in the state. Creating an exemption for sales of diesel fuel would eliminate a portion of the revenues that would normally be appropriated to the Public Transportation Account.
6. **Proposed exemption could be difficult for retailers to administer.** The proposed exemption for sales of diesel fuel would apply only to sales of diesel fuel used in food processing and in producing and harvesting agricultural products and transporting those products to market. Retailers would be required to obtain and retain documentary evidence supporting any claimed exempt sales. This would require a trucker to provide documentary evidence to the fuel retailer about the type of product they are transporting and where they are transporting it in order to support the exemption. This would be very difficult since truckers often purchase diesel fuel from card-lock locations where there is no attendant to adjust the price of diesel at the pump for the exemption or obtain documentary evidence from the purchaser to support the exemption.

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- 7. Partial tax exemptions are difficult to administer.** Due to the method used to report partial tax exemptions, any return containing a claimed partial tax exemption must be processed manually for the proper allocation of local taxes. Current law provides for two partial tax exemptions: sales of manufacturing equipment and teleproduction equipment. The number of returns affected by these current partial tax exemptions are relatively minor. However, this proposed exemption would cause a significant increase in the number of returns filed containing the partial tax exemption. Additionally, diesel fuel is generally sold at the pump for a tax-included price. Since the proposed exemption would only apply to some sales of diesel fuel, retailers may incur difficulties adjusting the sales price for exempt sales of diesel fuel.
- 8. Interstate users of diesel would continue to pay an amount equivalent to the sales tax.** Pursuant to Sections 60115 and 60116 of the Diesel Fuel Tax Law, interstate users must pay an excise tax on each gallon of diesel fuel used in this state at a tax rate of 18 cents per gallon plus an amount equivalent to the rate of sales tax imposed on diesel fuel purchased in this state. Interstate users can subsequently claim a credit for the total amount of the tax on each gallon used outside California provided they actually paid the tax to an in-state retailer. These provisions in the law were added by AB 1269 (Ch. 618, 1997) in order to eliminate the incentive for an interstate user to tank up outside California. Without conforming amendments to Sections 60115 and 60116, interstate users would still be required to pay the equivalent sales tax component on their use of diesel fuel in this state, provided this bill were enacted.
- 9. Prepayment requirements could cause cash flow problems for some diesel fuel suppliers.** Under current law, when diesel fuel retailers purchase the fuel from their suppliers, the retailers are required to pay the suppliers the sales tax prepayment, currently at the rate of 8 cents per gallon. A credit for the amount of that prepayment may then be claimed by the retailer on the sales tax return in which the sales of the diesel fuel are reported. If this provision is enacted, those diesel fuel retailers that have substantial sales to farmers or food processors could be in the position of making prepayments to their suppliers that far exceed their sales tax liability. This would result in credit returns for which the retailers would be required to wait for the Board to issue refunds for the overpayment – a situation that could create cash flow difficulties for some diesel fuel retailers.
- 10. Related Legislation.** This bill contains similar language as AB 19X (Briggs) which died when the First Extraordinary Session was adjourned, and AB 16XX (Briggs), which is currently held in the Assembly Appropriations Committee. Other measures include AB 37 (Strickland), which would provide a permanent exemption from the sales and use tax for diesel fuel and gasoline; AB 1636 (Briggs), which would provide a sales and use tax exemption for sales of diesel fuel; and SB 835 (Battin), which would provide a sales and use tax exemption for the state and federal excise tax imposed on gasoline or diesel fuel. The Board has taken a neutral position on all these measures.

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COST ESTIMATE

Some additional administrative workload would be realized as a result of notifying affected retailers, processing claims for refund, and responding to inquiries. Due to the partial tax exemption, additional resources will be needed to process returns in order to ensure the proper allocation and payment of local and district taxes. A detailed cost estimate of the workload impact is pending.

REVENUE ESTIMATE**Background, Methodology, and Assumptions**

The average retail price (less sales tax and state excise tax) of diesel fuel in California during the third quarter of 2000 was \$1.4833 per gallon. According to the U.S. Energy Information Administration (EIA), consumption of diesel fuel for farming activities in California amounted to 220.5 million gallons in 1999. Estimated gallonage during the 12-month period beginning September 1, 2001 is 225.3 million. Total sales of diesel fuel used during this period are estimated to be \$334.2 million (225.3 million gallons x \$1.4833 per gallon = \$334.2 million).

This provision would include within the definition of farming activities the transportation and delivery of farming supplies to farmers and the transportation and delivery of farm products to the marketplace. According to the U.S. Census Bureau's 1997 Economic Census of Transportation and Warehousing, revenues for those firms engaged in the transportation of agricultural products accounted for 3.35% of the total trucking industry revenue in California. If we apply this percentage to the total gallons of diesel used annually on-highway in California – 2.4 billion gallons – estimated gallons used in transporting agricultural products would amount to 80.4 million gallons. (2.4 billion gallons x .0335 = 80.4 million gallons.) At an average price of \$1.4833 per gallon, annual sales amount to \$119.4 million. (80.4 million gallons x \$1.4833 = \$119.4 million.)

Total sales that would be exempted by this provision are estimated to be \$453.6 million (\$334.2 million + \$119.4 million = \$453.6 million). Note, this estimate does not include amounts attributable to food processing.

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Revenue Summary

Current law provides that the sales tax revenue at the 4 $\frac{3}{4}$ percent rate from the sale of diesel fuel is allocated on a quarterly basis to the Public Transportation Account, with any remainder going to the General Fund. The annual revenue loss from exempting diesel fuel used in farming activities from the state sales and use tax would be as follows:

| | |
|---------------------------------------|-----------------------|
| Public Transportation Account (4.75%) | \$21.6 million |
| General Fund (.25%)* | <u>\$1.1 million</u> |
| Total | <u>\$22.7 million</u> |

An estimate of the revenue loss associated with diesel fuel used in food processing is pending.

* While the state tax rate is 4.75 percent for calendar year 2001, it is assumed the tax rate will return to 5.0 percent in 2002.

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Race Horse Breeding Stock:**Current Law**

The existing Sales and Use Tax Law imposes a tax on the sale of, or the storage, use, or other consumption in this state of, tangible personal property, unless that property is specifically exempted or excluded by statute. Generally, sales of horses and any other animals are subject to tax to the same extent as any other sales of tangible personal property. However, existing law does provide the following exemptions or exclusions with respect to sales and other types of transfers of animals:

- Section 6010.40 excludes from the computation of sales and use tax any receipts associated with the transfer by a local government animal shelter or a nonprofit animal welfare organization of any animal to an individual for use as a pet.
- Section 6358 provides an exemption for the sale or purchase of any form of animal life the products of which ordinarily constitute food for human consumption (e.g., sales and purchases of cows, bees, and chickens are exempt from tax).
- Section 6366.5 provides an exemption for the sale and purchase of endangered or threatened animal and plant species if both the seller and the purchaser are nonprofit zoological societies.

For purposes of establishing whether a horse is subject to ad valorem property tax or to the race horse in lieu tax, the Board's Property Tax Rule 1046 provides in part that a horse used for breeding purposes means a registered male animal that has serviced three or more registered females for the purpose of producing a racehorse during the two previous calendar years or a registered female animal that has been bred to a registered male for the purpose of producing a racehorse during the two previous calendar years.

Proposed Law

This bill would add Section 6358.5 to the Sales and Use Tax Law to exempt from the state General Fund sales and use tax rate, the sale and purchase of any race horse breeding stock.

The bill would define "race horse breeding stock" to mean a horse that is capable of reproduction and for which the purchaser states that it is the purchaser's sole intent to use the horse for breeding purposes.

The provisions of this portion of the bill would become effective September 1, 2001, or, October 1 if the Board determines that implementation by September 1 is not feasible. In such a case, the Board would be required to report to the Legislature on the reasons why it must delay implementation.

Background

Other bills proposing to provide an exemption for thoroughbred horses have been considered in the past. AB 2757 (Wright) of the 1987-88 Legislative Session would have provided an exemption similar to this measure, and would have additionally exempted receipts attributable to stallion services, sales of thoroughbred horses less than two years of age sold to an out-of-state resident that are transported outside

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California, receipts for boarding and training thoroughbred horses, and the temporary use of thoroughbred horses within this state for purposes of racing, exhibiting, or performing. AB 2679 (Wright) of the 1986-87 session would have created an exemption for the sale and purchase of a thoroughbred horse or an Arabian horse which is used as breeding stock.

COMMENTS

- 1. Sponsor and Purpose.** The author is the sponsor of this measure. The purpose of this provision is to assist California purchasers who wish to acquire race horse breeding stock without the added expense of tax on their acquisitions.
- 2. Proponents view this measure as an enhancement to revenues and an opportunity to make California a more friendly place to the race horse industry.** Proponents of this provision point out that this exemption could ultimately enhance the sales and use tax base, since an incentive would be created to breed more horses for racing purposes. Since the final sale of a race horse would remain subject to tax, proponents believe that California's sales and use tax revenues would actually be enhanced. As an example, a horse bred to race may be sold as a yearling for \$3,000 and then compete as a race horse at a value of \$10,000. According to statistics maintained by The Jockey Club, the State of Kentucky annually leads the list of states producing registered thoroughbred foals, consistently increasing its share in recent years. From the top 12 foal producing states, only Kentucky, Florida, and Pennsylvania have produced more registered foals in 1999 than at the start of the decade. For more than a quarter of a century, since The Jockey Club began computerized analysis of the foal crop, Kentucky has been followed by California and Florida. In 1994, however, Florida overtook California to become the nation's second largest producer of registered thoroughbred foals. Under Kentucky's Sales and Use Tax Law, all sales of horses are exempt from tax. Florida exempts the sale of a race horse by its owner provided the owner is also the breeder of the animal. Proponents of this exemption see this bill as an opportunity to "spur" the race horse industry in California and to make California's tax climate more competitive with the two leading states in the production of registered thoroughbred foals.
- 3. Related legislation.** This measure is similar to AB 904 (Briggs), which the Board voted to oppose. The California Thoroughbred Breeders Association sponsored AB 904.

COST ESTIMATE

Some costs would be incurred in notifying affected taxpayers, answering inquiries, and reviewing claimed exemptions on returns. An estimate of these costs is pending.

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REVENUE ESTIMATE**Background, Methodology, and Assumptions**

There are a number of sales conducted annually by only a few organizations: Barretts, American Equine, and the California Thoroughbred Breeders Association. The largest of those organizations is Barretts, an auction company that makes four sales per year. Sales of race horses include yearlings, two-year olds, and two-year olds in training. It is assumed that any race horse except for geldings could be used as breeding stock. Sales of race horses for the year 2000 are comprised of the following:

| | |
|-------------------------------|-----------------------|
| Del Mar Yearling Sale | \$ 4.1 million |
| Barretts | |
| January Sale | \$ 2.1 million |
| March Sales | \$17.3 million |
| May Two-Year-Olds in Training | \$ 5.0 million |
| October Mixed Sales | \$ 2.7 million |
| American Equine | <u>\$ 0.8 million</u> |
| Total | <u>\$32.0 million</u> |

Revenue Summary

The annual revenue loss from exempting \$32 million from the 5 percent* state sales and use tax is estimated to be \$1.6 million.

* While the state tax rate is 4.75 percent for calendar year 2001, it is assumed the tax rate will return to 5.0 percent in 2002.

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REVENUE SUMMARY FOR ALL PROVISIONS

| | General Fund* | Public Transportation Account | Local | Total |
|---------------------------------|------------------|-------------------------------------|---------------|----------------|
| Liquid petroleum gas | \$ 8.3 million | | \$4.8 million | \$13.1 million |
| Farm machinery and equipment | 22.5 | | | 22.5 |
| Timber harvesting equipment | 2.0 | | | 2.0 |
| Diesel fuel | 1.1 | \$21.6 million | | 22.7 |
| Thoroughbred horses | 1.6 | | | 1.6 |
| <hr/> | | | | |
| Total | \$35.5 million | \$21.6 million | \$4.8 million | \$61.9 million |
| <hr/> | | | | |

* While the state tax rate is 4.75 percent for calendar year 2001, it is assumed the tax rate will return to 5.0 percent in 2002.

| | | | |
|-----------------------|-------------------|----------|----------|
| Analysis prepared by: | Sheila T. Sarem | 445-6579 | 07/23/01 |
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